

DEPARTMENT OF STATE REVENUE
REVENUE RULING IT 97-01

August 4, 1997

NOTICE: Under IC 422-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

STATEMENT OF FACTS

The Company is a Delaware limited partnership organized in December, 1986 to acquire, own and operate, through its subsidiary partnership, the Operating Partnership, the business and assets of the Original Corporation. On January 1, 1987, the Original Corporation contributed all of its assets to the Operating Partnership in exchange for a 99% limited partnership interest in the Operating Partnership and a promissory note. The Operating Partnership assumed all of the liabilities of the Original Corporation. In turn, the Original Corporation and affiliates contributed their 99% limited partnership interest in the Operating Partnership to the Company in exchange for 11,099,573 Class A and 22,199,146 Class B limited partnership interests in the Company. 10,700,590 of these Class A and B limited partnership interests have been sold to public investors through a syndicate of securities dealers. A portion of these interests have been sold to nine S corporations, each of which is individually owned by a different member of the management of the Operating Partnership. 11,099,573 Class B interests were contributed to SBP. The balance of the interests were retained by the Original Corporation. Both the Original Corporation and SBP subsequently have been liquidated and their Class A and B limited partner interests sold.

The Operating Partnership is a wholesale distributor of industrial products. Its products fall into four basic groups: fluid power products, such as hydraulic and pneumatic systems and parts; maintenance products, such as fasteners and automotive aftermarket small parts; electrical products such as cable, lamps and lighting fixtures; and glass products such as large sheet glass, auto glass, insulating glass, mirrors and specialty glass. The products are sold to a variety of customers in the replacement/maintenance and construction markets and to original equipment manufacturers and a diverse range of retail distributors.

The Operating Partnership distributes quarterly its available cash from operations, as defined in the partnership agreement, to its partners (the Company and the General Partner) in accordance with their 99% and 1% interests, respectively, in the Operating Partnership. The partners' share of all items of income, deductions, gain and loss is distributed to them, on a reporting basis, after the close of each calendar year. In turn, cash available for distribution and items of income, deduction, gain or loss are distributed by the Company to the General Partner and to the owners of the units of limited partnership interests. Similarly, the General Partner will make distributions to its partners, who are the Corporation and the nine Management S Corporations.

The holders of the limited partnership interests in both the Company and the Operating Partnership have no rights or powers to participate in the management of the partnerships. The ultimate responsibility for the overall management of the partnerships rests with the General Partner. While the General Partner provides significant assistance to the Operating Partnership in the areas of long range planning and strategic management decision making, the daily management of the Operating Partnership's business operations is handled by its own management employees. The General Partner is entitled to receive a management fee from the Operating Partnership equal to 3% of the aggregate capital investment of the limited partners of the Company. This fee is not paid until priority cash distributions are paid to the limited partners of the Company, and if not paid on a current basis because of insufficient available cash, is deferred until there is sufficient cash available.

The syndication of the Company's Units of limited partnership interests made these Units available to investors across the country. Some Units are registered with the Company in the "street name" of the participating securities dealers. The distributions of cash and items of income, deduction, gain or loss, are issued by the Company principally to nominees who redistribute the cash and income items to the real unitholders. The identities and addresses of the actual unitholders or beneficial owners of the interests in many cases are known only to the securities dealers. As a result, the company may not have the necessary information to report the identities of the actual Public Investor unitholders, nor the amounts distributable to them. The Company has this information with respect to its distributions to the General Partner and the Management S corporations, as well as the aggregate information for each nominee.

The Operating Partnership

The Operating Partnership is a Delaware limited partnership with its headquarters in Pennsylvania. Its two partners are the General Partner, 1% general partnership interest, and the Company, 99% limited partnership interest. The Operating Partnership is engaged in the business of wholesale distribution of industrial products. The Operating Partnership is operating in Indiana to such an extent to require that it file Indiana partnership returns. Neither of the partners are Indiana residents.

The Company

The Company is a Delaware limited partnership which owns a 99% limited partnership interest in the Operating Partnership. The Company's 1% general partner is the General Partner who is also the general Partner of the Operating Partnership. The Company's limited partners are the Capital Partner, the nine S Corporations which are owned individually by management employees of the Operating Partnership, and public investors. The Company's headquarters is also in Pennsylvania.

The Company exists solely for the purpose of owning the limited partnership interests in the Operating Partnerships. Its only activities consist of the receipt and redistribution of distributions from the Operating Partnership to the other limited partners, the public investors, and the General Partner. It engages in no other activities either within or without of Pennsylvania. Its only connection to any other state is as a limited partner in the Operating Partnership. It is possible that one or more of the public investors of the company are residents of Indiana. However, to the extent that a nominee holds the investment in a street name, the Company may not have this information available.

The General Partner

The General Partner is a Delaware limited partnership which owns a 1% general partner interest in both the Operating Partnership and the Company. The general partner of the General Partner is the Corporation. The limited partners of the General Partner are the nine S Corporations.

The General Partner is also headquartered in Pennsylvania. The General Partner has no employees, no other business locations, no tangible personal property, and no other business activities other than as general partner of the partnerships.

The Corporation

The Corporation is a Delaware corporation headquartered in Pennsylvania. In its capacity as the general partner of the General Partner, through its three officers (all of whom are Pennsylvania residents and work at the Operating Partnership's headquarters), provides management services for both the Operating Partnership and the Company. All management services take place in Pennsylvania.

The S Corporations

There are nine S Corporations, each of which is owned by a different member of the management of the Operating Partnership. Each S Corporation owns a percentage of the respective limited partner interests in the Company and the General Partner. Five of the S Corporations are incorporated in Delaware and domiciled in Pennsylvania. One is incorporated in Delaware and domiciled in Illinois. The remaining S Corporations are incorporated and domiciled in the residences of their sole shareholders' residences in Missouri, North Carolina, and Ohio, respectively.

As limited partners in the above partnerships, the S Corporations are not conducting activities in any other state than their state of domicile. Their activities are limited to the receipt, investment and redistribution of the limited partnership distributions.

ISSUES, DISCUSSION AND RULINGS

ISSUE

Are the nonresident limited partners of the Company subject to income tax in Indiana?

DISCUSSION

Partners in a partnership with Indiana source income are subject to the adjusted gross income tax. 45 IAC 3.1-1-106(a) states, "... partners will include their share of partnership income whether distributed or undistributed on their separate or individual returns." 45 IAC 3.1-1-153(a) states, "[a] corporate partner's share of profit or loss from a partnership will be included in its federal taxable income and therefore generally subject to the same rules as any other adjusted gross income."

Nonresident partners pay adjusted gross income tax on their distributive share of partnership income after apportionment. 45 IAC 3.1-1-106(b)(2). Nonresident individuals or corporations with Indiana source income are required to file an Indiana income tax return without limitation. IC 63-4-1. Taxpayers which have Indiana net operating losses for the year are not technically required to file an Indiana return. However, the taxpayer will have to file a return if they wish to carry forward any remaining losses. Nonresident partners with losses may also need to file Indiana returns in order to recover amounts withheld by the partnership pursuant 45 IAC 3.1-1-107.

Incorporated partners of a partnership with Indiana source income are also subject to the gross income tax on their distributive shares. 45 IAC 1-1-159.1(b) states, "[a]n amount credited to a corporate partner as its distributive share

of partnership income which is derived from sources within Indiana is subject to the gross income tax, provided the partnership has not previously paid the gross income tax due on such income." However, corporations which elect S status, or which meet the requirements to elect S status and choose not to so elect, are exempt from the gross income tax pursuant to IC 6-2.1-3-24 and IC 6-2.1-3-24.5.

Neither 45 IAC 3.1-1-106 nor 45 IAC 3.1-1-153 distinguishes between general partners or limited partners or between publicly traded partnerships and closely held partnerships. However, 45 IAC 1-1-155.1 indicates that a partnership that is treated as a corporation pursuant to IRC § 7704 is subject to the gross income tax. The corporate partners of such a corporation would not be subject to gross income tax pursuant to 45 IAC 1-1-159.1(b). None of the partnerships involved in this business structure qualify as a publicly traded partnership pursuant to IRC § 7704. Therefore, none of them is subject to the gross income tax on its Indiana receipts and all of the corporate partners that are not otherwise exempt are subject to gross income tax on the partner's distributive share after apportionment pursuant to 45 IAC 1-1-159.1(c).

RULING

All partners in any of the partnerships in question which have Indiana source income are subject to Indiana adjusted gross income tax. Indiana source income will flow through the partnerships and S corporations until it reaches a taxpaying entity who is then required to file an Indiana income tax return and pay Indiana adjusted gross income tax. Partners or shareholders which are corporations which are not otherwise exempt from Indiana gross income tax, i.e. S corporations or special corporations pursuant to IC 6-2.1-3-24 or IC 6-2.1-3-24.5, must pay the Indiana gross income tax and those corporations not electing S status, i.e. C corporations and special corporations, must also pay Indiana supplemental net income tax. Entities that only act like a conduit in this structure are required to file the appropriate informational returns.

ISSUE

How do the corporate partners apportion their Indiana source income?

DISCUSSION

How an incorporated partner determines its Indiana liability depends on its relationship to the partnership. Corporate partners that have a unitary relationship with the partnership figure their Indiana liability by combining factors with the partnership pursuant to 45 IAC 3.1-1-153(b). Corporate partners that do not have a unitary relationship with the partnership determine their share of the partnership income attributable to Indiana by subjecting the partnership's income to apportionment pursuant to 45 IAC 3.1-1-153(c). The corporate partner's share of partnership income subject to Indiana adjusted gross income tax will be equal to the corporate partner's pro rata share of the partnership's apportioned Indiana income.

"A corporate partner's share of profit or loss from a partnership [is]... subject to the same rules as any other adjusted gross income." 45 IAC 3.1-1-153(a). This regulation restates the obvious; income received from a partnership is treated as if it were received directly by the taxpayer. Partners do not receive partnership income in a vacuum. Partnership income retains all the characteristics it acquired when earned by the partnership until it reaches the level of a taxpaying entity. When a partnership is required to file an Indiana partnership return, all the partners are required to file an Indiana income tax return. When a corporation is required to file a corporate income tax return, IC 6-3-2-2(a) requires that the corporation report all its income and not just that portion attributable to partnership interests resulting in Indiana source income. IC 6-3-2-2(b) only requires that business income be apportioned once. Therefore, when partnership income is apportioned pursuant to 45 IAC 3.1-1-153(c), it should not be reapportioned by the corporate partner.

RULING

Indiana source income should be apportioned by the Operating Partnership and passed through on a pro rata basis to its partners. The upper tier partnerships and S corporations should pass through the Indiana income to their partners and shareholders on a pro rata basis without re-apportioning. In the event that any of the upper tier partnerships or corporations have any Indiana source income other than that generated by the Operating Partnership, then that partnership or corporation should apportion that additional income and add it to the already apportioned income which originated with the Operating Partnership.

ISSUE

Will Indiana recognize the S election of the nine management corporations?

DISCUSSION

Corporations which elect S status pursuant to IRC § 1363 are exempt from adjusted gross income tax, IC 6-3-2-2.6, gross income tax IC 6-2.1-3-24, and supplemental net income tax, IC 6-3-8-2. 45 IAC 3.1-1-67 requires that corporations electing S status file an information return and a copy of the form making the S election for federal purposes. There is no separate election requirement for state purposes. As long as the nine management S corporations followed these procedures, Indiana would recognize their S election.

The S corporations may file composite returns on behalf of their nonresident shareholders if they follow the procedures put forth in Income Tax Information Bulletin #72.

RULING

Indiana will recognize the S election of the nine management corporations.

ISSUE

Do any of the partnerships have to withhold Indiana income tax on the distributions to the public investors holding limited partnership interests in the Company?

DISCUSSION

Based on the facts presented, it is likely that the only entity with Indiana source income is the Operating Partnership. The Operating Partnership distributes 99% of its income to the Company and 1% to the General Partner. The General Partner distributes its income, all of which is generated by the Operating Partnership, to the Corporation and the nine management S corporations. The Company distributes its income, all of which is generated by the Operating Partnership, to the public investors and the nine management S corporations with 1% going to the General Partner. The result of this business structure is that the tax paying entities, individuals and C corporations, are not direct partners or shareholders of the entity, the Operating Partnership, which generates Indiana source income. This complex arrangement also makes the application of Indiana withholding requirements problematical.

A partnership is required to withhold income taxes on any nonresident partner's distributive share of partnership income. 45 IAC 3.1-1-107. The same requirement is imposed on S corporations in 45 IAC 3.1-1-109. 45 IAC 3.1-107(a)(2) states, "[f]or a partner other than an individual partner, the income tax withheld may be calculated using any reasonable method designed to reflect the *ultimate* tax liability..." (emphasis added). By definition, the withholding required by 45 IAC 3.1-1-107 can only apply to partners which are subject to Indiana income taxation. However, The income remains taxable Indiana source income and the partnership operating in Indiana is responsible for withholding based on the ultimate liability to the ultimate taxpayer.

The statutes and regulations requiring withholding do not differentiate between general or limited partners or between closely held or widely traded partnerships. The fact that withholding from a large number of limited partners is impractical, or even impossible, does not change the withholding requirement. The burdens for filing and withholding are somewhat alleviated by allowances for composite returns, Income Tax Information Bulletin #72, and nominee withholding, Income Tax Information Bulletin #85.

RULING

The Operating Partnership or any other partnership or S corporation which distributes Indiana source income to pass through entities are required to withhold Indiana income tax from those distributions based on the liability of the ultimate taxpayer.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, changes in a statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.